
From: Eugene Kim </O=EXCHANGELABS/OU=EXCHANGE ADMINISTRATIVE GROUP (FYDIBOHF23SPDLT)/CN=RECIPIENTS/CN=7B1951ECC94F4D7FAB0133BCCB1867AB-EUGENE KIM>
To: Tim Stuart; Kevin Gammill; Kendra Goodenough; Sarah Bond; Ben Decker; Ryan Cooper (CORPDEV); Jamie Lawver; Christian Staples (CORPDEV)
CC: David Hampton; Luca Di Mauro; Anna Chen; Louis Aghanwa
Sent: 11/1/2019 4:34:00 AM
Subject: RE: Project Phoenix - Preliminary Discussion Materials re: Scarlett Exclusivity

Team –

As promised, I'm also attaching the latest draft of the SA memo. This draft incorporates Phil's feedback from our session last week, as well as some minor formatting tweaks.

I'm also attaching a slightly updated version of the discussion materials for everyone's reference.

Thanks,
Eugene

From: Eugene Kim
Sent: Thursday, October 31, 2019 6:06 PM
To: Tim Stuart [REDACTED] >; Kevin Gammill [REDACTED] >; Kendra Goodenough [REDACTED] >; Sarah Bond [REDACTED] >; Ben Decker [REDACTED] >; Ryan Cooper (CORPDEV) [REDACTED] >; Jamie Lawver [REDACTED] >; Christian Staples (CORPDEV) [REDACTED] >;
Cc: David Hampton [REDACTED]; Luca Di Mauro [REDACTED]; Anna Chen [REDACTED]; Louis Aghanwa [REDACTED]
Subject: Project Phoenix - Preliminary Discussion Materials re: Scarlett Exclusivity

Team –

In advance of tomorrow's discussion, please find a short set of discussion materials attached. I plan to share the revised SA memo later this evening.

- The attached analysis is focused on evaluating the economic trade-off between selling Phoenix console content exclusively on Scarlett vs. selling on competing consoles
- Completing this part of the analysis first will help us find a "starting point" to evaluate other synergies such as acceleration of Xbox Game Pass & TAM expansion on mobile and in Asia
- We intend for this to be a starting point for the discussion, as opposed to a definitive recommendation
- Note that we are still working through a few specific data points
 - For example, we still need to provide an estimate of future incremental revenue & GM from selling Phoenix content that is currently not available on Xbox to existing Xbox owners
- We have also provided an outline of how we are approaching Phil's broader ask concerning a "domino effect" of industry consolidation in the event that we acquire a large publisher
 - This is illustrative and intended to spur discussion; some of this analysis will fall beyond the scope of our immediate work on Project Phoenix

We look forward to a healthy discussion tomorrow – please let us know if you have any feedback or questions in advance of our discussion.

Thanks,
Eugene

Eugene Kim | Microsoft Corporation
Gaming Business Planning & Strategy



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STRATEGY APPROVAL: SQUARE ENIX

By the Gaming Leadership Team | November 2019

1. | Market Opportunity & Our Strategy

In 2018, the gaming industry generated \$170 billion in total revenue, larger than the global home video (\$50 billion), movie box office (\$47 billion), and music industries (\$47 billion) combinedⁱⁱ. The game industry continues to grow—software and services revenue is projected to grow 11% annually through 2022—and yield healthy profit margins, ~30% for platforms and publishers in aggregate. One in three people in the world plays video games, 2.4 billion globally. In the next decade, we estimate that the number of worldwide gamers will grow to exceed 4 billion. Asia drives nearly half of industry revenue and worldwide gamersⁱⁱⁱ. Today, Microsoft accounts for just under 7% of the game industry^{iv}, implying significant headroom for growth.

Gamers increasingly play on multiple devices, with mobile seeing nearly universal adoption. Games are often bound to certain device categories however, a byproduct of legacy relationships and technical limitations. The recent success of *Fortnite* illustrates the latent demand for more fluid access to games across devices, as is typical in other entertainment categories. We believe the industry will reorganize, moving from a device-centric paradigm to one that orients around the gamer.

Microsoft has the opportunity to expand our presence in a large and growing industry by powering this transformation, including establishing relationships with more gamers on more endpoints in more geographies. Our strategy is to enable gamers to play the games they want, with the people they want, anywhere they want. This requires:

- **Content:** to attract & engage gamers across our platform & services
- **Community:** to create an ecosystem for discovery, purchase, and engagement
- **Cloud:** to provide ubiquitous content access and presence across endpoints

2. | Accelerating Our Strategy

The Role of Content

The Gaming CSA continuously evaluates opportunities to accelerate the growth of our business. Similar to other industries such as video, where investment in securing IP is projected to grow 30-50% in 2018-2020,^v having access to relevant content is one of the single most important drivers in both console growth (where an exclusive AAA release accounts for a ■■■% console share shift in the US and a ■■■% shift worldwide) and Xbox Game Pass growth (8 out of the top 10 titles played by new users are major releases and account for more than ■■■% of total hours played). For this reason, we believe that the following investment areas would yield outsized returns:

Growth Opportunities

Proven Content to Accelerate Xbox Game Pass

We believe gaming will follow the trajectory of other consumer entertainment verticals such as music and video, where subscriptions are the primary growth driver. We are investing to meet this demand through Xbox Game Pass, which provides subscribers with access to more than 100 games across console & PC for a monthly fee. While Xbox Game Pass is currently the leading game content subscription service with more than 9 million paid subscribers across console & PC, it faces

increasing competition from incumbent players such as Electronic Arts and Sony, and new entrants including Apple and Google. Over time, we expect Xbox Game Pass, with Microsoft Store, to become our primary consumer-facing platform across devices. Our intent is to create a channel through which publishers can distribute and monetize their games, both inside and outside of the content subscription. To achieve this goal and compete in a crowded marketplace, we will need to accelerate subscriber scale, and exclusive hit content is the most effective lever to do so.

Tentpole Content to Bolster Project Scarlett

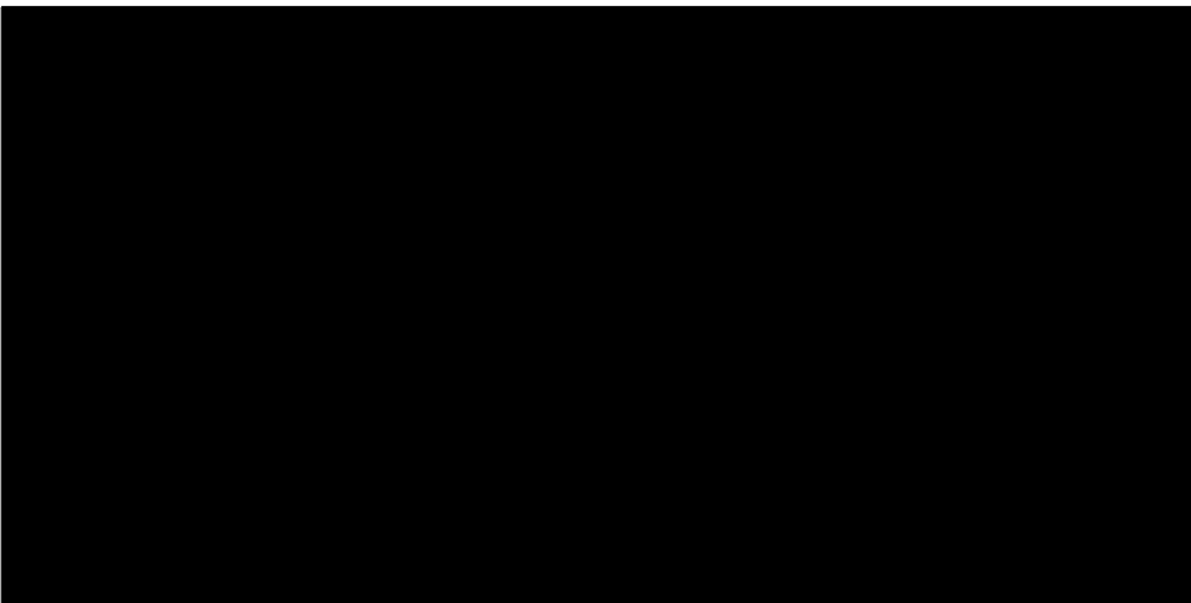
We are on the cusp of a new console generation, code-named "Project Scarlett." Scarlett is critical to our near- and long-term strategy, driving the economics of the business while laying the foundation for our cloud-native future. In particular, Scarlett provides Microsoft ongoing relevance with gamers and publishers during this transition. Based on historical precedents, we believe that differentiated content experiences will be key to Scarlett's success. While we have a strong portfolio of tentpole experiences (e.g., *Halo*, *Minecraft*, *Gears of War*), Sony and Nintendo enjoy meaningful advantages on this front. Ultimately, additional tentpole content will make Scarlett more attractive to gamers, creating a powerful on-ramp to Xbox Game Pass & xCloud.

TAM Expansion

- **Mobile Segment Growth:** Today, mobile gaming captures more than 40% of total industry revenue, generating over \$72 billion in 2018. The segment has grown double digits year over year and is expected to generate over \$100 billion by 2022ⁱ. Further, ~95% of the 2.4 billion worldwide gamers participate in mobile gamingⁱⁱⁱ. Currently, Microsoft does not have a meaningful presence in mobile, presenting significant opportunity to grow. In growing our addressable market, we aim to address mobile both via a cloud-native delivery of high fidelity games to a mobile endpoint (xCloud) and mobile-native games. To realize this strategy, we need a catalog of console-quality content as well as an at-scale mobile-native catalog with a geographically diverse and dedicated fan base.
- **Extend Our Reach in Asia:** In order to reach 2.4 billion worldwide gamers, we must also expand our addressable market to Asia, which accounts for half of the world's gamers and industry revenue. We currently have a minimal presence in Asia. To compete in these markets, we will need to diversify our content offerings to include new platforms, genres, and franchises that resonate with gamers in Asia.

3. | Square Enix Overview

Headquartered in Tokyo, Japan, Square Enix is a developer & publisher of video games for console, PC, and mobile. The company has ~4,600 employees based across three continents (Asia, North America, & Europe), and owns 10+ game development studios, as well as a publishing arm that partners with promising independent developers. The company also owns amusement and comic publishing businesses, which mainly cater to the Japanese domestic market and would not be value drivers for Microsoft.



Square Enix owns a diverse suite of gaming franchises that could serve as a cornerstone of our strategy, helping us extend our offerings beyond console and our current markets. Relative to comparable game publishers, Square Enix is differentiated by a higher share of revenue from mobile & PC (58% of gaming revenue), its strength in Asia (47% of gaming revenue), and a deeper stable of gaming IP.

Proven Content to Accelerate Xbox Game Pass, Bolster Project Scarlett

An acquisition of Square Enix would provide valuable content assets that could accelerate the growth of Xbox Game Pass and drive success for Project Scarlett. Additionally, the company's content portfolio spans across segments, with strength on console (42% of FY2019 gaming revenue), PC client (16%), browser (12%), and mobile (30%)^{vi}. This diverse portfolio could create multiple sources of value in both the near- and long-term:

- **Blockbuster franchises to drive Xbox Game Pass and Scarlett:** Square Enix's three core franchises (*Final Fantasy*, *Dragon Quest*, *Tomb Raider*) are blockbuster successes, collectively selling nearly 300 million lifetime units. Owning these franchises would help differentiate our platform's key content offerings, and help drive adoption of Xbox Game Pass and Scarlett. All three of these franchises launched on console with subsequent extensions to PC and/or mobile, and remain popular amongst the core console audience.
- **Complementary franchises & back catalog to drive Xbox Game Pass:** Square Enix also actively invests in 4-5 other studios that produce complementary franchises (e.g. *Kingdom Hearts*, *Deus Ex*) with devoted global fan bases. The company also owns an extensive back catalog, with hundreds of titles spread across three decades. Square Enix's extensive game library would provide Xbox Game Pass additional catalog depth to improve subscriber retention and broader genre coverage to attract new subscribers.

TAM Expansion in Mobile and Asia

- **Mobile Segment Growth:** Given our limited presence in mobile today, an acquisition of Square Enix would materially accelerate our growth ambitions and grow our addressable market. Notably, Square Enix's mobile gaming business drove ~\$550M of FY2019 revenue, close to one-third of its total gaming revenue. The company's expertise in developing mobile games could also help create opportunities for mobile expansion of our existing franchises. As we seek to create future offerings around mobile (e.g. via Xbox Game Pass), having a suite of proven mobile content will be a valuable asset.
- **Extend Our Reach in Asia:** Acquiring Square Enix would provide Gaming with market relevance in a region that currently lacks a meaningful Xbox presence, allowing us to reach more gamers in more geographies. In FY2019, the company earned nearly half of its gaming revenue from Asia. Additionally, Square Enix's franchises primarily focus on the role-playing & action-adventure genres, which are popular in Asia.

4. | Integration Plan

The ultimate integration plan for Square Enix will need to be determined in conjunction with the company's management team as part of due diligence and planning. However, [REDACTED]

Given our stated objectives of bolstering Xbox Game Pass, providing a strong content foundation for Project Scarlett, and reaching new gamers in Asia, we would run the acquired business as follows:

- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]

5. | Value Drivers of Acquisition

Synergies

We anticipate several key synergies that would help drive value-to-Microsoft:

Accelerate Xbox Game Pass Growth on Console, PC, and xCloud

Adding proven performers like *Final Fantasy & Dragon Quest* to the Xbox Game Pass catalog will materially accelerate the growth of the service. We believe that this acceleration will manifest itself as a combination of:

- **Increased subscriber-months** from new subscribers joining the service and churn reduction from existing subscribers
- **Increased monetization** through subscribers' migration to the premium Xbox Game Pass Ultimate (XGPU) SKU and more post-sale monetization opportunities (through an expanded audience for any specific title)

[REDACTED]

1. [REDACTED]

Gather a "Critical Mass" of Content to Support Future Mobile-Native Xbox Game Pass Offerings
Combining Square Enix's robust mobile-native portfolio with our own could potentially help us create a mobile-native Xbox Game Pass SKU. Square Enix's deep mobile catalog includes several premium titles (similar to console, with up-front pay gates) that would have substantial value for a subscription service. Additionally, we believe that an expanded catalog of mobile-native Xbox Game Pass titles could lower the cost of aggregating mobile-native content from other publishers. We believe that this acceleration will manifest itself as a combination of:

- **Increased subscriber-months** from new mobile-first subscribers and/or churn reduction from existing XGPU subscribers who value mobile content
- **Increased monetization** through increased migration to the premium XGPU SKU, which would include this new mobile content

Going Concern & Dis-synergies

We will continue to ship and operate all of Square Enix's currently announced & released games across all relevant platforms. This would add substantial first-party revenue across console, PC, and mobile.

Our operating plan calls for us to ship all future Square Enix releases into Xbox Game Pass on a day & date basis and preference Project Scarlett. We anticipate that this plan would have a negative impact on Square Enix's existing transactional gaming business by cannibalizing some portion of base game sales on both owned & competing endpoints.

[REDACTED]

6. | Key Risks

While Square Enix presents a meaningful opportunity for Gaming, we are cognizant of the following risks:

- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]

7. | Request for Strategy Approval

The opportunity to accelerate our ambitions in gaming is now. As the industry undergoes meaningful transition, new economic value will be created and existing economic value will be reorganized. Other key Microsoft competitors (e.g., Amazon, Google, etc.) perceive this shift as well, and are also investing in Content, Community, and Cloud. Acquiring Square Enix would create meaningful and sustained differentiation in this competitive environment.

ⁱ Consensus analyst estimates, public filings, internal analysis ("CY2018 Game Industry Sizing").

ⁱⁱ PricewaterhouseCoopers ("Global Entertainment and Media Outlook, 2016-2020"). Home video includes DVDs, video-on-demand, streaming services. Music includes CDs, digital purchases, subscription services, & ticket sales.

ⁱⁱⁱ Newzoo reports, internal analysis ("CY2018 Gamer Value").

^{iv} Public financial disclosure, equity research, internal analysis ("CY2018 Game Industry Profit Pools").

^v Matthew Ball Consulting.

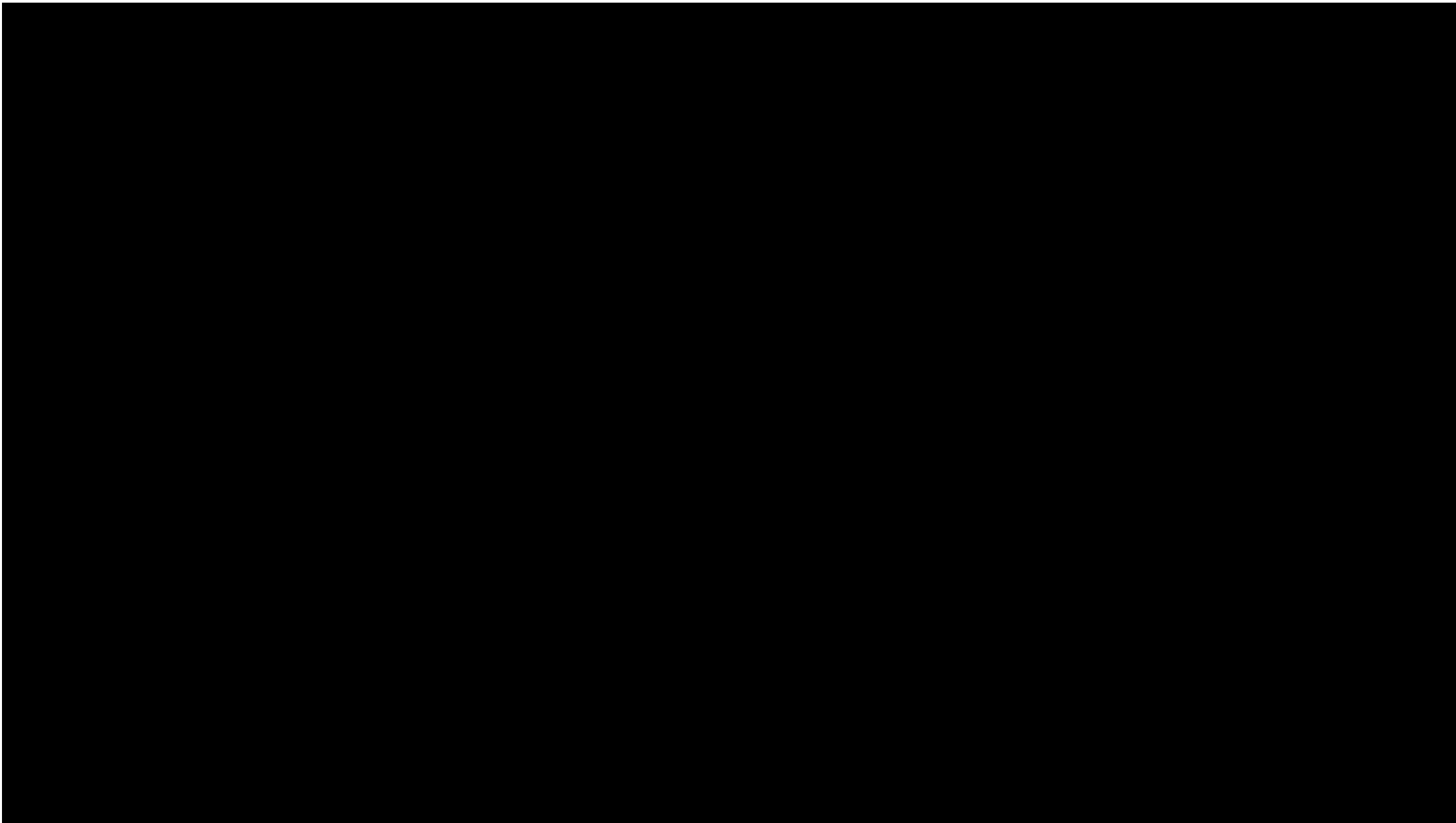
^{vi} Square Enix public financial disclosure.

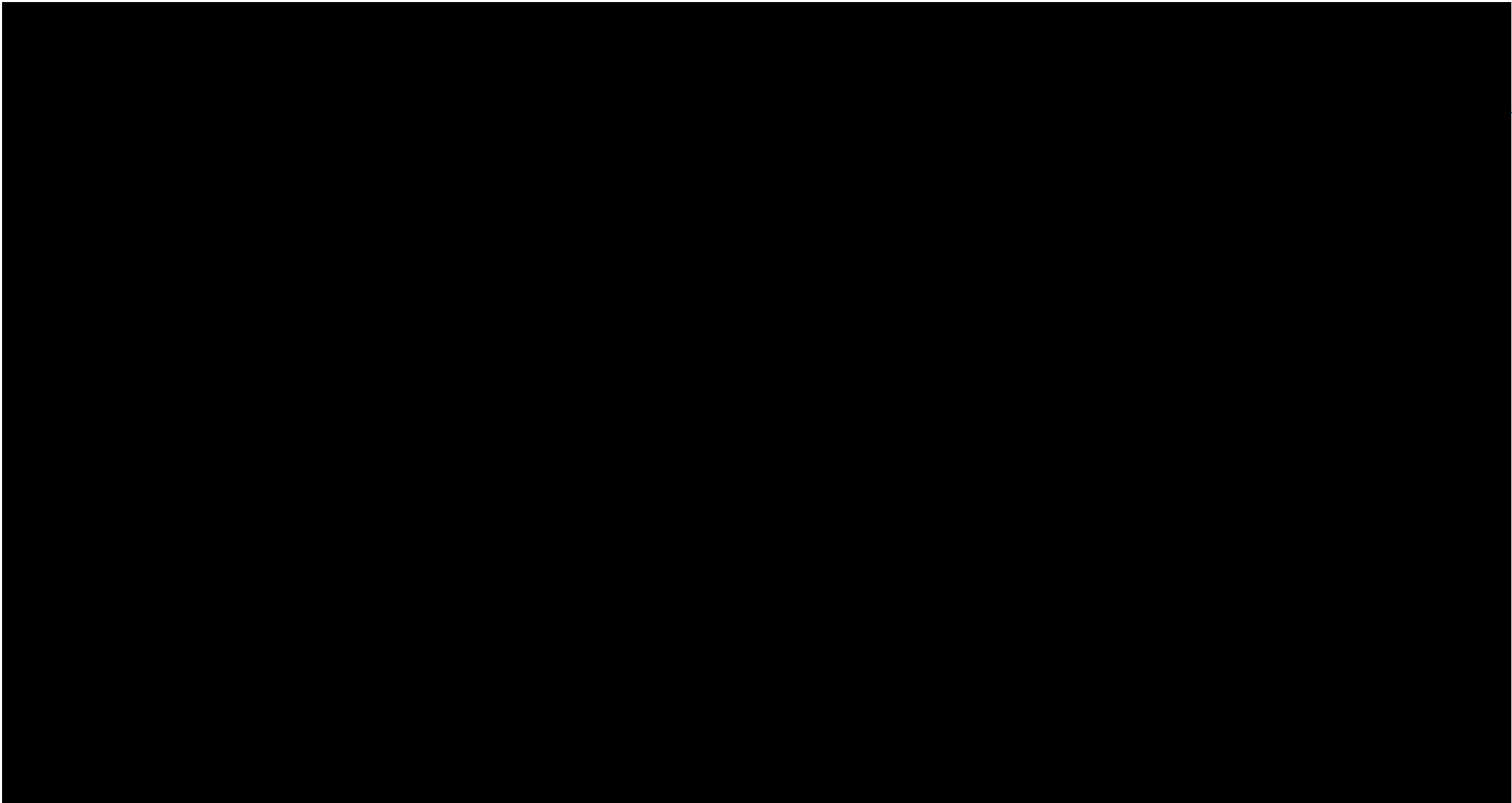
^{vi} Square Enix public financial disclosure.

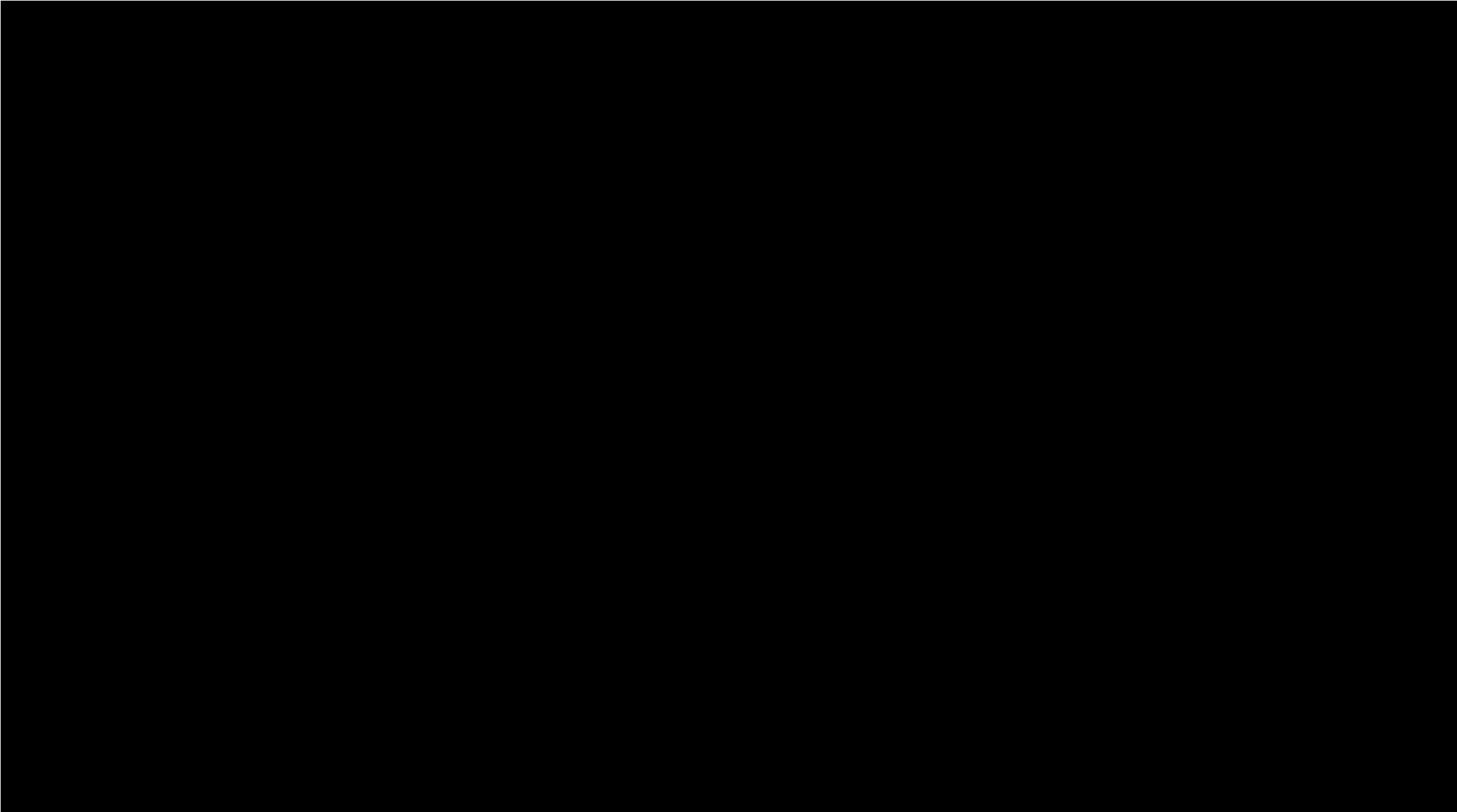
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Square Enix - Console Share Shift Modeling Framework.pptx

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(Primary)\Top of Information Store\Inbox\RE: Project Phoenix - Preliminary Discussion Materials re: Scarlett Exclusivity







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FYE March 31,

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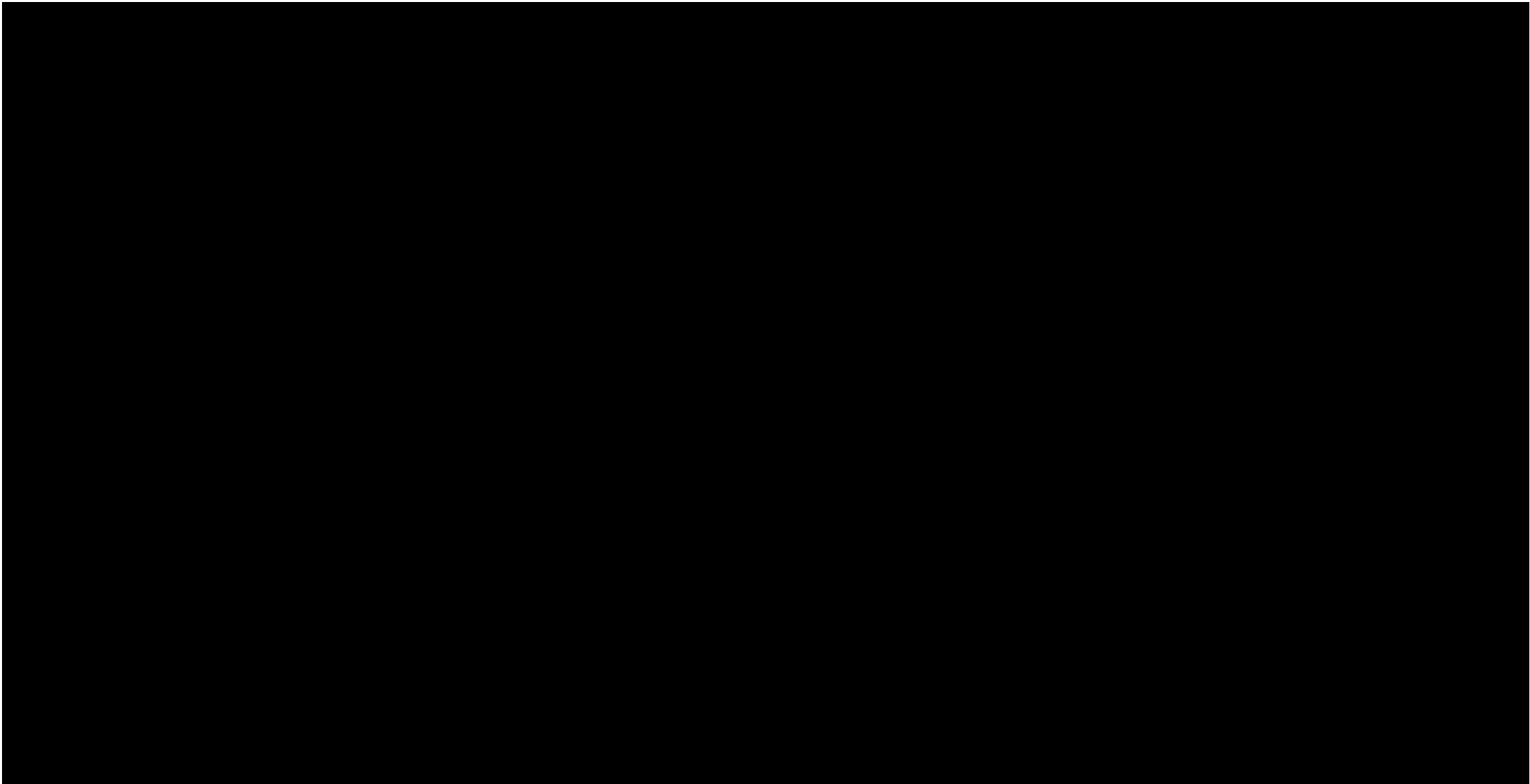
[REDACTED]

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- [REDACTED]
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[REDACTED]					
[REDACTED]					
[REDACTED] % for PS/Switch Phoenix gamers	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
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[REDACTED]



Graveyard

